



Billing Code: 8025-01

## SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

RIN 3245-AG67

### Small Business Investment Companies: Passive Business Expansion and Technical Clarifications

AGENCY: U.S. Small Business Administration.

ACTION: Final rule and withdrawal of final rule.

SUMMARY: The U.S. Small Business Administration (SBA) is withdrawing the final rule concerning Small Business Investment Company (SBIC) investments in passive businesses that was published on December 28, 2016, and is replacing it with this final rule. This final rule expands SBIC permitted investments in passive businesses and includes new reporting and other requirements for passive investments. This rule also makes a few minor technical amendments.

DATES: As of [insert date of publication in the Federal Register], the final rule published December 28, 2016 (81 FR 95424), delayed until March 21, 2017, on January 26, 2017 (82 FR 8499), further delayed until May 20, 2017, on March 21, 2017 (82 FR 14428), and further delayed until August 18, 2017, on May 2, 2017 (82 FR 20433), is withdrawn. The amendments in this rule are effective [INSERT DATE 30 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Theresa Jamerson, Office of Investment and Innovation, (202) 205-7563 or [sbic@sba.gov](mailto:sbic@sba.gov).

SUPPLEMENTARY INFORMATION:

## I. Background Information

The SBIC Program is an SBA financing program authorized under Title III of the Small Business Investment Act of 1958, 15 U.S.C. 681 et seq. Congress created the Small Business Investment Company (SBIC) program to “stimulate and supplement the flow of private equity capital and long-term loan funds, which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply . . . .” 15 U.S.C. 661. Congress intended that the program “be carried out in such manner as to insure the maximum participation of private financing sources.” Id. In accordance with that policy, SBA does not invest directly in small businesses. Rather, through the SBIC Program, SBA licenses and provides debenture leverage (Leverage) to SBICs. SBICs are privately-owned and professionally managed for-profit investment funds that make loans to, and investments in, qualified small businesses using a combination of privately raised capital and Leverage guaranteed by SBA. SBA will guarantee the repayment of debentures issued by an SBIC up to a maximum of \$150 million or three times the amount of the SBIC’s qualifying private capital, whichever is less (although pursuant to SBA’s regulations and credit policies, SBA rarely approves an SBIC to have a maximum amount of Leverage outstanding in excess of two times the amount of the SBIC’s qualifying private capital).

SBICs are generally prohibited from investing in passive businesses under the Act. Prior to this final rule, the SBIC program regulations provided for the following two exceptions that allowed an SBIC to structure an investment utilizing a passive small business as a pass-through:

A. “Holding company exception” - § 107.720(b)(2): This exception provides conditions under which an SBIC may structure an investment through up to two levels of passive entities to make an investment in a non-passive business that is a subsidiary of the passive business directly financed by the SBIC. The regulation defines a subsidiary company as one in which the financed passive business directly or indirectly owns at least 50% of the outstanding voting securities. As an example, this exception allows an SBIC to finance ABC Holdings 1, a passive small business, with the proceeds flowing through ABC Holdings 2, another passive small business, and then to ABC Manufacturing, a non-passive small business in which ABC Holdings 1 owns directly or indirectly at least 50% of the outstanding voting securities.

B. “Blocker corporation exception” - § 107.720(b)(3): This exception enables a partnership SBIC, with SBA's prior approval, to provide financing to a small business through a passive, wholly-owned C corporation, but only if a direct financing would cause one or more of the SBIC's investors to incur Unrelated Business Taxable Income (UBTI). A passive C corporation formed under the second exception is commonly known as a blocker corporation.

On October 5, 2015, SBA published a proposed rule, Small Business Investment Companies: Passive Business Expansion and Technical Clarifications (80 FR 60077), to further expand the permitted use of passive businesses, provide clarification with regard to investments in such businesses, and make minor technical clarifications. SBA received three comments on the proposed rule, not including one comment that generally questioned the fairness of the Act as a whole and did not provide any specific comments on the rule. The three comments pertinent to the rule are addressed in Section II.

On December 28, 2016, SBA published a final rule regarding SBIC investments in passive businesses, 81 FR 95419, which had an effective date of January 27, 2017. On January 26, 2017, SBA published a notice in the Federal Register at 82 FR 8499, to delay the effective date of the final rule until March 21, 2017, and to re-open the rule for additional public comment in accordance with the memorandum dated January 20, 2017, from the Assistant to the President and Chief of Staff, entitled “Regulatory Freeze Pending Review.” SBA received one comment that supported the December 2016 final rule. On March 21, 2017, SBA published another notice to delay the effective date of the final rule until May 20, 2017, to give the new administration time to further consider the rule. 82 FR 14428. After completing its review, SBA issued another delay notice at 82 FR 20433 (May 2, 2017), which stated that SBA was considering removing a provision in the final rule published on December 28, 2016 that would allow SBICs to use a blocker corporation if an investor in an SBIC had elected to be taxed as a regulated investment company (RIC), and if a direct investment into the operating company would jeopardize the investor’s RIC status. As part of this document, SBA asked for additional comments regarding the removal of this provision, and delayed the effective date of the December 28, 2016 final rule until August 18, 2017. SBA received one comment in response to its proposed change. This comment is addressed in Section II.

SBA is withdrawing the final rule published on December 28, 2016, and is replacing it with this final rule. This final rule expands permitted investments in passive businesses, provides further clarification with regard to investments in such businesses, and adds certain requirements to improve SBA’s ability to monitor such investments. The rule also includes a conforming change to the regulations regarding the amount of

Leverage available to SBICs under common control to be consistent with the Consolidated Appropriations Act, 2016, Public Law 114-113, 129 Stat. 2242 (December 22, 2015), which increased the maximum amount of such Leverage from \$225 million to \$350 million.

## II. Section-by-Section Analysis

This section discusses the comments SBA received on the proposed rule dated October 5, 2017 (80 FR 60077), as well as the comment received in response to the notice published on May 2, 2017 (82 FR 20433).

### A. Passive Business Rules

#### Section 107.720 – Small Businesses that may be ineligible for financing.

1. Changes to Holding Company Exception § 107.720(b)(2): SBA proposed revisions to § 107.720(b)(2) to explicitly permit an SBIC to form and finance a passive business that will either pass the proceeds through to or use the proceeds to acquire all or part of a non-passive business. These changes were intended to codify SBA’s existing interpretation of the regulations.

SBA received two comments on § 107.720(b)(2) indicating that the proposed changes would be more effective if the passive business directly financed was not required to own at least 50 percent of the underlying active business. Commenters also suggested that SBICs be allowed to structure investments using passive investment vehicles “irrespective of the number of parent entities involved so long as the parent entities in question directly or indirectly own or control at least 50 percent of the voting or economic interests of the active business.” SBA received similar comments as part of the rulemaking process when it last proposed expanding the permitted use of passive

businesses on December 23, 2013 (78 FR 77377). SBA considered these comments a second time in developing this final rule; however, neither set of comments was adopted. SBA believes that complex investment structures involving passive entities require more protections, not fewer. Although the new § 107.720(b)(4) should help address some of SBA's credit concerns with respect to these structures, SBA believes that the subsidiary relationship between the financed passive business and the active company must be maintained to facilitate SBA's access to the information and records needed to effectively monitor these transactions and to aid in the recovery of assets in the event of a default. SBA also maintains its position that effective monitoring of transactions with unlimited levels of passive companies would require resources well beyond those available to the Agency. Proposed § 107.720(b)(2) is adopted without change.

2. Changes to Blocker Corporation Exception - § 107.720(b)(3): The proposed rule included the following changes to § 107.720(b)(3):

- a. Removing the requirement to obtain SBA's prior approval to form a blocker corporation;
- b. Permitting an SBIC to form a blocker corporation to enable any foreign investors to avoid effectively connected income (ECI) under the Internal Revenue Code;
- c. Permitting a blocker corporation to provide financing to a second passive small business that passes the proceeds through to a non-passive small business in which it owns at least 50 percent of the outstanding voting securities (effectively permitting an investment structured with two levels of passive companies, one of which is the blocker corporation); and

d. Removing outdated language indicating that an SBIC's ownership of a blocker corporation formed under § 107.720(b)(3) will not constitute a violation of § 107.865(a). This provision was rendered unnecessary by a rule change in 2002 (67 FR 64789) that revised § 107.865(a) to permit an SBIC to exercise control over a small business for up to seven years without SBA approval.

SBA received comments on proposed § 107.720(b)(3) as discussed below:

a. Regulated Investment Company (RIC) Exception. All three commenters asked that the regulations provide an additional exception for SBICs that are wholly owned subsidiaries of Business Development Companies (BDCs). A BDC typically elects to be taxed as a RIC pursuant to Subchapter M of the Internal Revenue Code of 1986. In general, a RIC is not subject to U.S. Federal income taxes on income and gains that it distributes to stockholders, provided that it satisfies certain minimum distribution requirements. To qualify as a RIC, a BDC must satisfy certain source of income and asset-diversification tests; among other things, a RIC must generally derive at least 90% of its gross income for each taxable year from certain types of investment. In particular, the commenters explained that equity interests in pass-through entities (such as an LLC or S corporation) generate operating income that, if received or deemed received directly by a BDC, could disqualify the BDC from maintaining RIC status, and therefore, such interests must often be held through a blocker corporation. The commenters requested that § 107.720(b)(3) be revised to permit an SBIC to form a blocker corporation to avoid adverse tax consequences to an investor (typically a parent BDC) that has elected to be taxed as a RIC.

The final rule published on December 28, 2016 (81 FR 95419) adopted this comment. However, in the delay notice published on May 2, 2017 (82 FR 20433), SBA stated that it was considering removing this provision and solicited comment from the public on that proposed action. The notice cited SBA's concern that, in light of the increased complexities involved in monitoring and examining investments structured through blocker entities, the expanded use of such entities could increase risk to the SBIC program unless SBA were to increase examination resources to monitor these complex transactions. The notice further explained that while SBA expects limited use of blocker entities for the purposes of avoiding UBTI and ECI (because these situations apply to only a few SBICs), SBA would expect significantly greater usage of blocker entities by SBICs that are subsidiaries of BDCs that have elected to be taxed as RICs. Currently, there are 31 SBICs with BDC investors (BDC-SBICs) that collectively account for over 23% of SBA's outstanding Leverage, and SBA expects that most of them would make use of blocker entities if the RIC exception were to be finalized.

SBA received one comment stating that not including the RIC exception would prevent BDC-SBICs from taking equity positions and benefiting from the upside afforded by equity investments. While the commenter strongly supported SBA's goal of protecting taxpayers, the commenter believed that this goal may be better served by including the RIC exception and thereby increasing a BDC-SBIC's potential for maximizing profits. The commenter further noted that the profits from a single successful equity investment can offset losses on other investments and that SBA's guarantee is protected by a BDC-SBIC's portfolio as a whole. The commenter suggested that SBA consider creating the RIC exception, but making the exception subject to SBA



prior approval. SBA recognizes that not including the RIC exception for blocker corporations limits a BDC-SBIC's ability to execute some transactions; however, due to the large amount of outstanding Leverage held by BDC-SBICs, SBA remains concerned that these investments would unacceptably increase risk to SBA absent an increase in SBA's resources to monitor and examine such investments. Adding a requirement for SBA's prior approval of a blocker entity does not address this concern; SBA would still need to review and approve the transactions and examine each of the passive businesses used in the transaction. For this reason, this final rule does not include the RIC exception. SBA notes that BDC-SBICs may still take equity positions in small businesses not structured as pass through entities and also may invest using any passive structure permitted under § 107.720(b)(2).

b. Blocker Entity Form of Organization. At the proposed stage of this rule, SBA received two comments suggesting that non-corporate forms of organization should be permitted for blocker entities. The commenters explained that these structures are often "more streamlined in terms of corporate formalities than a C corporation" and suggested the regulations allow "any entity that elects to be taxed as a corporation for Federal income tax purposes." SBA considered this suggestion to be overly broad, but partially adopted this suggestion in this final rule by allowing a blocker entity to be structured as an LLC that elects to be taxed as a corporation.

c. Two Level Holding Company Financing. Two commenters indicated that § 107.720(b)(3) should allow SBICs to structure a financing with a blocker entity coupled with two additional levels of passive holding companies as defined in § 107.720(b)(2). The commenters stated that the proposed rule puts an SBIC that requires a blocker entity

to accommodate its investors at a disadvantage compared to other SBICs that do not require a blocker entity, since the blocker entity can only finance a single passive business entity that in turn makes an investment into an active business. For example, an SBIC with a foreign investor would not be able to participate in a financing that is structured as a two-level passive business financing under § 107.720(b)(2), if it also needed a separate passive business to serve as a blocker entity in order to avoid effectively connected income. If adopted, this suggestion would effectively permit up to three levels of passive businesses between the SBIC and the operating business. These additional levels of passive businesses impose a burden on SBA as regulator and increase the Agency's credit risk. SBA believes that two levels of passive businesses under either exception should provide SBICs with sufficient flexibility to operate successfully, and this final rule does not adopt the suggested change.

d. SBA did not receive any comments on the proposed change to § 107.720(b)(3) regarding the removal of outdated language. This rule adopts the change as proposed.

3. Additional Passive Business Guidance - § 107.720(b)(4): The proposed rule identified SBA's concerns with regard to passive investments, including ensuring the financing dollars go to the eligible non-passive small business, fees being charged at each passive business level, and SBA's ability to access passive business financial records, especially in the case of a defaulting SBIC. To address these concerns, SBA proposed making the following changes in new § 107.720(b)(4), which would apply to any eligible passive investment made under § 107.720(b)(2) or (b)(3):

a. "Substantially All" Definition. Clarifying the meaning of "substantially all" in § 107.720(b)(2) and (b)(3) to mean 99 percent of the financing proceeds after deduction

of actual application fees, closing fees, and expense reimbursements, which may not exceed those permitted under § 107.860.

b. Fee Requirements. Requiring fees charged by an SBIC or its Associate under §§ 107.860 and 107.900 to not exceed those permitted if the SBIC had directly financed the eligible Small Business and requiring any such fees received by an SBIC's Associate to be paid to the SBIC in cash within 30 days of receipt.

c. "Portfolio Concern" Clarification. Clarifying that both passive and non-passive businesses included in a financing are "Portfolio Concerns"; therefore, they are subject to record keeping and reporting obligations with respect to any "Portfolio Concern," defined in § 107.50 as "a Small Business Assisted by a Licensee."

SBA received 3 comments on proposed § 107.720(b)(4) as discussed below:

a. "Substantially All" Definition. Commenters suggested that the definition of "substantially all" be lowered to 95 percent of the proceeds instead of 99% of the proceeds because they were concerned that the 99 percent threshold "may be too limiting and pose issues in deal structuring." SBA did not adopt this comment. The definition already excludes allowable fees and expense reimbursements permitted under §§ 107.860 and 107.900, and SBA believes that a 95 percent threshold could result in excessive expenses being charged by the passive businesses, effectively diverting proceeds from the intended operating business. Although this percentage may seem inconsequential, 4% of a \$20 million financing represents \$800,000 that could be diverted from the operating business.

b. Fee Requirements. Two commenters suggested removing the requirement that fees received by an Associate must be paid over in cash to the SBIC. They noted that

SBIC program policy guidance known as TechNote 7a, which provides guidelines concerning allowable management expenses for leveraged SBICs (see [www.sba.gov/sbicpolicy](http://www.sba.gov/sbicpolicy)), already requires that 100% of fees collected under § 107.860 or § 107.900 must benefit the SBIC, either by being paid directly to the SBIC or (if paid to an Associate) through a corresponding reduction in the management fee paid by the SBIC, typically called a “management fee offset.” Commenters also indicated that management fee offsets have tax advantages relative to other approaches. Although SBA recognizes that management fee offsets can provide tax advantages, SBA did not adopt this suggestion because of the difficulty in monitoring investments utilizing passive businesses and identifying fees associated with each passive business in addition to those paid by the operating business.

c. “Portfolio Concern” Clarification. Two commenters indicated that the clarification of Portfolio Concern should be revised to apply only “for the purposes of this part 107.720” to avoid any unintended effects arising from the use of the term “Portfolio Concern” in other sections of the regulations. The commenters indicated that this adjustment would still allow SBA to retain the necessary information rights contemplated by the proposed rule. A search for the term “Portfolio Concern” within the regulations identified the following:

- § 107.50 defines “Portfolio Concern” as “a Small Business Assisted by a Licensee.”
- §§ 107.600 -107.660 describe record keeping and information requirements, including those for a Portfolio Concern.
- § 107.730 discusses conflicts of interest with regards to Portfolio Concerns.

- § 107.760 discusses how a change in size or activity affect the Licensee with regard to a Portfolio Concern.
- § 107.850 discusses restrictions on redemption of Equity Securities of a Portfolio Concern.

SBA believes that all of the requirements in these sections are applicable to passive business financings. Therefore, this suggestion was not adopted.

4. Section 107.610 Required certifications for Loans and Investments. The proposed rule also added a certification requirement to § 107.610 to require an SBIC that finances a business under § 107.720(b)(3) to certify as to the qualifying basis for such financing. The certification replaces the requirement for SBA prior approval of the formation and financing of a blocker corporation.

As previously discussed under the changes to § 107.720(b)(3) paragraph, the December 2016 final rule, 81 FR 95419 (December 28, 2016), would have permitted the formation of a blocker entity by an SBIC with an investor that had elected to be taxed as a RIC. Since this final rule does not include the RIC exception, that portion of the certification requirement has been removed from § 107.610 in this final rule. The final § 107.610 adopts the proposed rule (80 FR 60077) language with respect to the formation of blocker entities to accommodate investors subject to UBTI or ECI with minor technical changes to clarify these two permitted exceptions.

#### B. Technical Changes

SBA also proposed the following technical changes to the regulations:

1. Section 107.50 Definition of terms. Changing “Associates’s” to “Associate’s”.

2. Section 107.210 Minimum capital requirements for Licensees. Modifying paragraph (a) of § 107.210 to allow both Leverageable Capital and Regulatory Capital to fall below the stated minimums if the reductions are performed in accordance with an SBA-approved wind-up plan per § 107.590(c), to conform with SBA's current oversight practices.

3. Section 107.503 Licensee's adoption of an approved valuation policy. Changing the last sentence of § 107.503(a) to indicate that valuation guidelines for SBICs may be obtained from the SBIC program's public website, [www.sba.gov/sbic](http://www.sba.gov/sbic).

4. Section 107.630 Requirement for Licensees to file financial statements with SBA (Form 468). Removing current § 107.630(d), which provides a mailing address for submission of SBA Form 468, and re-designating paragraph (e) as paragraph (d). These instructions are no longer necessary because SBICs submit this information electronically using the SBA's web-based application.

5. Section 107.1100 Types of Leverage and application procedures. Correcting the misspelling of "Yu" to "You" and removing paragraph (c), which identifies where to send Leverage applications. This paragraph is unnecessary because the application forms provide these instructions.

None of the comments SBA received in response to the proposed rule were related to these technical changes. This final rule incorporates these changes as proposed.

#### C. Increase to Maximum Leverage to SBICs Under Common Control

Section 521 of the Consolidated Appropriations Act, 2016, amended section 303(b)(2) of the Act to increase the maximum amount of Leverage available to two or

more SBICs under Common Control from \$225 million to \$350 million. SBA defines Common Control in 13 CFR 107.50 to mean a condition where two or more persons, either through ownership, management, contract, or otherwise, are under the control of one group or person. SBA presumes that two or more SBICs are under Common Control if, among other things, they have common officers, directors, or general partners. Currently, 13 CFR 107.1150(b) limits two or more SBICs under Common Control to the maximum aggregate amount of outstanding Leverage of \$225 million, which amount is subject to further limitations under SBA's credit policies. Solely as a conforming change, this rule increases the maximum amount set forth in the regulation from \$225 million to \$350 million. This statutory change was not addressed previously because it had not yet been enacted when the rule was proposed. Now that it has, the technical change has been included to ensure consistency between the regulations and the current law.

Compliance with Executive Orders 12866, 12988, 13132, 13563, and 13771, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601-612).

Executive Order 12866

The Office of Management and Budget has determined that this rule is not a “significant” regulatory action under Executive Order 12866. This is also not a “major” rule under the Congressional Review Act, 5 U.S.C. 801, et seq.

Executive Order 12988

This rule meets applicable standards set forth in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The rule does not have retroactive or presumptive effect.

#### Executive Order 13132

This final rule will not have substantial direct effects on the States, or the distribution of power and responsibilities among the various levels of government. Therefore, for the purposes of Executive Order 13132, Federalism, SBA determines that this rule has no federalism implications warranting the preparation of a federalism assessment.

#### Executive Order 13563

This final rule was developed in response to comments received on previously proposed amendments to these regulations on investments in passive businesses. *See* 78 FR 77377 (December 23, 2013). SBA received one set of comments on that proposed rule that suggested changes to further liberalize permitted financings to passive businesses under § 107.720(b). In response to the comment, SBA indicated in the related final rule published on October 21, 2014 (79 FR 62819), that it would further consider the suggested changes in a future rulemaking. As part of that reconsideration, SBA discussed the comments with industry representatives and solicited additional comments in the proposed rule published in October 2015 at 80 FR 60077. In December 2016, SBA published a final rule that reflected the industry feedback, as well as comments from the general public. 81 FR 95419 (December 28, 2016). After reconsideration of that published final rule in accordance with the memorandum, dated January 20, 2017, from the Assistant to the President and Chief of Staff, entitled “Regulatory Freeze Pending



Review,” as discussed above, on three separate occasions SBA delayed implementation of the rule. SBA also solicited additional comments from the public. Any comments received in response to those requests were also considered in finalizing this rule.

#### Executive Order 13771

This rule is not an EO 13771 regulatory action because this rule is not significant under EO 12866.

#### Paperwork Reduction Act, 44 U.S.C. Ch. 35

SBA has determined that this rule would impose additional reporting and recordkeeping requirements under the Paperwork Reduction Act. In particular, this rule implements changes to the Portfolio Financing Report, SBA Form 1031 (OMB Control Number 3245-0078), to clarify information to be reported in Parts A, B, and C of the form. Both the proposed rule (80 FR 60077) and the December 2016 Final Passive Business Rule (81 FR 95419) included additional questions in a new Part D on the Form 1031 to collect information regarding Impact SBIC investments. These additions were related to the proposed rule, entitled “Impact SBICs,” published on February 3, 2016 (81 FR 5666), which would have defined a new class of SBICs in the regulations. However, because SBA is not finalizing that rule, these questions are no longer required and have been removed from the Form 1031. As a result, proposed Parts E and F have been designated as Parts D and E, respectively, in the revised Form 1031 and are discussed in detail below.

The title, description of respondents, description of the information collection and the changes to it are discussed below with an estimate of the revised annual burden. Included in the estimate is the time for reviewing instructions, searching existing data

sources, gathering and maintaining the data needed, and completing and reviewing each collection of information.

Title: Portfolio Financing Report, SBA Form 1031 (OMB Control Number 3245-0078).

Summary: SBA Form 1031 is a currently approved information collection. SBA regulations, specifically § 107.640, require all SBICs to submit a Portfolio Financing Report using SBA Form 1031 for each financing that an SBIC provides to a Small Business Concern within 30 days after closing an investment. SBA uses the information provided on Form 1031 to evaluate SBIC compliance with regulatory requirements. The form is also SBA's primary source of information for compiling statistics on the SBIC program as a provider of capital to small businesses. The proposed rule (80 FR 60077) invited the public to provide comments on the following changes to SBA Form 1031:

(1) Clarifying that SBICs should report the non-passive Small Business Concern information in the Form 1031. SBA has noted that SBICs sometimes report data on the passive Small Business Concern rather than the non-passive Small Business Concern when reporting financing information. SBA has clarified that the SBIC should report data on the non-passive Small Business Concern when reporting information on financings using passive businesses in the Form 1031 Part A- the Small Business Concern; Part B - the pre-financing data; and Part C - the financing information, with the exception of the financing dollars in Question 29. The amount of financing dollars provided by the SBIC should be the total amount of such financing, regardless of whether the dollars were provided directly or indirectly to the non-passive business concern. Example: The SBIC provides \$5 million in equity to ABC Holding Corporation, which

passes \$4.98 million to the non-passive business, Acme Manufacturing LLC. In addition, the SBIC provides \$5 million in debt directly to Acme Manufacturing LLC. The SBIC would report information on Acme Manufacturing LLC in Parts A, B, and C. However, the total financing dollars would be reported as \$5 million in equity and \$5 million in debt for a total of \$10 million in total financing dollars.

(2) Identifying financings using one or more passive businesses. SBA has added a question on whether the financing utilizes one or more passive businesses as part of the financing, to help SBA identify these financings.

(3) Adding information on passive business financings to aid in regulatory compliance monitoring. SBA has also added a requirement under the new Part D for SBICs to upload a file in Portable Document Format (PDF) that contains the following information, which SBA will use to help assess whether the financing meets regulatory compliance:

(a) Qualifying exception: Identification of the passive business exception under which the financing is made (i.e., § 107.720(b)(2) Exception for pass-through of proceeds to subsidiary, or § 107.720(b)(3) Exception for certain Partnership Licensees). If the SBIC indicates that the financing is made under § 107.720(b)(3), it would also indicate the qualifying basis for the financing (i.e., financing would cause an investor in the fund to incur unrelated business taxable income or effectively connected income).

(b) Passive Business Entities: Identification of the name and employer ID number for each passive business entity used within the financing. This is needed so that SBA can identify all Portfolio Concerns involved in the financing.

(c) Financing Structure Description: A description of the financing structure, including the flow of the money between the SBIC and the non-passive Small Business Concern that receives the proceeds (including amounts and types of securities between each entity), and the ownership from the SBIC through each entity to the non-passive Small Business Concern. This information will help SBA assess that the Small Business Concern receives “substantially all” the financing dollars and the ownership percentages are in compliance with the regulations. This will also help SBA with SBICs transferred to the Office of Liquidation to identify the structure of the financing and aid in recovery of SBA leverage.

SBA did not receive any comments on the proposed changes. Therefore, except as described above, all other changes are adopted as final in this rule. SBA updated the below burden estimates from the December 2016 final rule (81 FR 31489) to remove the Impact SBIC burden estimate and update the estimates based on the SBIC portfolio as of June 2017, more recent SBIC financing data, and updated hourly costs.

Description of Respondents and Burden: As of June 2017 there were approximately 316 licensed SBICs. All of these SBICs are required to submit SBA Form 1031 for each financing. The current estimated number of responses (i.e., number of financings) is 2,695 based on a recent three year period (FY 2014 through 2016). The current estimate indicates that it takes approximately 12 minutes to complete the form, for a total annual burden of 539 hours.

Neither the number of respondents nor the number of responses per year is expected to be affected by this rule. However, SBA estimates an increase in the burden

hours as a result of the additional reporting in new passive business reporting section, as discussed below.

Passive Business Reporting. SBA believes that the SBIC should be able to provide the passive business information since it should be readily available as part of the financing. SBA estimates that providing the information will take on average an additional 30 minutes for those financings utilizing passive businesses, with no incremental burden for those financings that do not use a passive business. SBA estimates that about 14% of the annual responses relate to passive businesses financings (based on financing data for the three year period of FYs 2014 through 2016). Based on the number of SBICs reporting such financings the total estimated annual hour burden resulting from Part D reporting would be 189.

Therefore, the total estimated annual hour burden for all SBICs submitting SBA Form 1031s in a year would be 728 hours.

The current cost estimate for completing SBA Form 1031 uses a rate of \$35 per hour for an accounting manager to fill out the form. Using that same rate, the cost per form would change from \$7 per form to \$9.45 per form. However, SBA has increased its estimate of an hourly rate for an accounting manager to \$46 per hour (estimated using [www1.salary.com/Accounting-Manager-hourly-wages.html](http://www1.salary.com/Accounting-Manager-hourly-wages.html) in May 2017), which rate results in a new cost per form of \$12.43 for an aggregate cost of \$33,488 for the 2,695 estimated responses.

This final rule also identifies information that an SBIC must maintain in its files to support the required changes. SBA believes that the SBICs should already be maintaining this information since a passive business by definition is a Portfolio Concern

and the SBIC should be maintaining all documents needed to support each financing. The rule makes this expectation explicit. Furthermore, currently, an SBIC must maintain this information for it to effectively monitor and evaluate an investment that uses a passive business to finance a non-passive business. Therefore, SBA does not believe this recordkeeping requirement increases the burden.

The rule also requires a certification under § 107.610 when the SBIC makes a financing using the exemption in § 107.720(b)(3). This includes maintaining records supporting the certification. Since this regulation effectively replaces the requirement for SBICs to seek prior SBA approval, SBA does not believe this change will increase the burden.

#### Regulatory Flexibility Act, 5 U.S.C. 601-612

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601, requires administrative agencies to consider the effect of their actions on small entities, small non-profit businesses, and small local governments. Pursuant to the RFA, when an agency issues a rule, the agency must prepare a Final Regulatory Flexibility Act (FRFA) analysis which describes whether the impact of the rule will have a significant economic impact on a substantial number of small entities. However, Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an FRFA, if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities. This rule would affect all SBICs, of which there are currently 316. SBA estimates that approximately 98 percent of these SBICs are small entities. Therefore, SBA has determined that this rule would have an impact on a substantial number of small entities. However, SBA has determined that the economic impact on entities affected by the rule would not be

significant. As discussed under the Paperwork Reduction Act section, SBICs would need to provide descriptions of the transactions in the Form 1031 for which the annual burden totals 189 hours for the 316 SBICs. Based on the estimated \$46 per hour, the cost for each SBIC would be approximately \$28 per year (189 hours divided by 316 SBICs multiplied by \$46 per hour). The changes in the passive business regulation provide SBICs with additional flexibility to employ transaction structures commonly used by private equity or venture capital funds that are not SBICs.

SBA asserts that the economic impact of the rule, if any, would be minimal and beneficial to small SBICs. Accordingly, the Administrator of the SBA certifies that this rule would not have a significant economic impact on a substantial number of small entities.

#### List of Subjects in 13 CFR Part 107

Investment companies, Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

For the reasons stated in the preamble, the Small Business Administration amends 13 CFR part 107 as follows:

#### PART 107 - SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for part 107 continues to read as follows:

Authority: 15 U.S.C. 681, 683, 687(c), 687b, 687d, 687g, 687m.

#### § 107.50 [Amended]

2. Amend § 107.50 by removing from the definition of “Lending Institution” the term “Associates’s” and adding in its place the term “Associate’s”.

3. Amend § 107.210 by revising paragraph (a) introductory text to read as follows:

§ 107.210 Minimum capital requirements for Licensees.

(a) Companies licensed on or after October 1, 1996. A company licensed on or after October 1, 1996, must have Leverageable Capital of at least \$2,500,000 and must meet the applicable minimum Regulatory Capital requirement in this paragraph (a), unless lower Leverageable Capital and Regulatory Capital amounts are approved by SBA as part of a Wind-Up Plan in accordance with § 107.590(c):

\*\*\*\*\*

4. Amend § 107.503 by revising the last sentence of paragraph (a) to read as follows:

§ 107.503 Licensee's adoption of an approved valuation policy.

(a) \*\*\* These guidelines may be obtained from SBA's SBIC website at [www.sba.gov/sbic](http://www.sba.gov/sbic).

\*\*\*\*\*

5. Amend § 107.610 by adding paragraph (g) to read as follows:

§ 107.610 Required certifications for Loans and Investments.

\*\*\*\*\*

(g) For each passive business financed under § 107.720(b)(3), a certification by you, dated as of the closing date of the Financing, as to the basis for the qualification of the Financing under § 107.720(b)(3) and identifying one or more limited partners for which a direct Financing would cause those investors:



(1) To incur “unrelated business taxable income” under section 511 of the Internal Revenue Code (26 U.S.C. 511); or

(2) To incur “effectively connected income” to foreign investors under sections 871 and 882 of the Internal Revenue Code (26 U.S.C. 871 and 882).

§ 107.630 [Amended]

6. Amend § 107.630 by removing paragraph (d) and redesignating paragraph (e) as paragraph (d).

7. Amend § 107.720 by revising paragraphs (b)(2) and (3) and adding paragraph (b)(4) to read as follows:

§ 107.720 Small Businesses that may be ineligible for financing.

\*\*\*\*\*

(b) \*\*\*

(2) Exception for pass-through of proceeds to subsidiary. You may provide Financing directly to a passive business, including a passive business that you have formed, if it is a Small Business and it passes substantially all the proceeds through to (or uses substantially all the proceeds to acquire) one or more subsidiary companies, each of which is an eligible Small Business that is not passive. For the purpose of this paragraph (b)(2), “subsidiary company” means a company in which the financed passive business either:

(i) Directly owns, or will own as a result of the Financing, at least 50 percent of the outstanding voting securities; or

(ii) Indirectly owns, or will own as a result of the Financing, at least 50 percent of the outstanding voting securities (by directly owning the outstanding voting securities of

another passive Small Business that is the direct owner of the outstanding voting securities of the subsidiary company).

(3) Exception for certain Partnership Licensees. If you are a Partnership Licensee, you may form one or more blocker entities in accordance with this paragraph (b)(3). For the purposes of this paragraph, a “blocker entity” means a corporation or a limited liability company that elects to be taxed as a corporation for Federal income tax purposes. The sole purpose of a blocker entity must be to provide Financing to one or more eligible, unincorporated Small Businesses. You may form such blocker entities only if a direct Financing to such Small Businesses would cause any of your investors to incur “unrelated business taxable income” under section 511 of the Internal Revenue Code (26 U.S.C. 511) or to incur “effectively connected income” to foreign investors under sections 871 and 882 of the Internal Revenue Code (26 U.S.C. 871 and 882). Your ownership and investment of funds in such blocker entities will not constitute a violation of § 107.730(a). For each passive business financed under this section 107.720(b)(3), you must provide a certification to SBA as required under § 107.610(g). A blocker entity formed under this paragraph may provide Financing:

- (i) Directly to one or more eligible non-passive Small Businesses; or
- (ii) Directly to a passive Small Business that passes substantially all the proceeds directly to (or uses substantially all the proceeds to acquire) one or more eligible non-passive Small Businesses in which the passive Small Business directly owns, or will own as a result of the Financing, at least 50% of the outstanding voting securities.

(4) Additional conditions for permitted passive business financings. Financings permitted under paragraphs (b)(2) or (3) of this section must meet all of the following conditions:

(i) For the purposes of this paragraph (b), “substantially all” means at least 99 percent of the Financing proceeds after deduction of actual application fees, closing fees, and expense reimbursements, which may not exceed those permitted by § 107.860.

(ii) If you and/or your Associate charge fees permitted by § 107.860 and/or § 107.900, the total amount of such fees charged to all passive and non-passive businesses that are part of the same Financing may not exceed the fees that would have been permitted if the Financing had been provided directly to a non-passive Small Business. Any such fees received by your Associate must be paid to you in cash within 30 days of the receipt of such fees.

(iii) For the purposes of this part 107, each passive and non-passive business included in the Financing is a Portfolio Concern. The terms of the financing must provide SBA with access to Portfolio Concern information in compliance with this part 107, including without limitation §§ 107.600 and 107.620.

\*\*\*\*\*

§ 107.1100 [Amended]

8. Amend § 107.1100 by removing the term “Yu” in the second to the last sentence of paragraph (b) and adding in its place “You”, and by removing paragraph (c).

§ 107.1150 [Amended]

9. Amend § 107.1150 by removing the term “\$225 million” in the first sentence of paragraph (b) and adding in its place “\$350 million”.

Dated: August 10, 2017.

Linda E. McMahon,  
Administrator.

[FR Doc. 2017-17456 Filed: 8/17/2017 8:45 am; Publication Date: 8/18/2017]